

VC sentiment rises again, high optimism is fraught with potential for setbacks

28 July 2023

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- Investors still have a negative view of the current situation, expectations rose significantly again
- Record high overhang of expectations is fraught with potential for setbacks
- Investment opportunities exist but investors remain hesitant

Expectations brighter than current situation

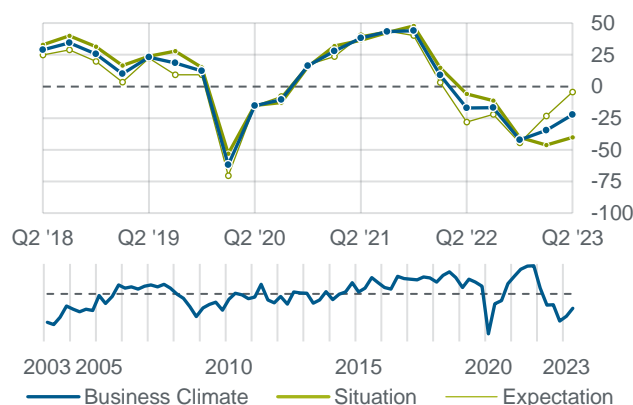
Sentiment in the German venture capital market improved again in the first half of 2023. The business climate indicator of the early-stage segment rose by 12.4 points to -22.2 balance points. That nearly made up for the downturn in sentiment recorded at the end of the year 2022. Situation assessments remain on a very low level, however, while business expectations were much more positive again for the second consecutive quarter. The indicator for the current business situation rose by a moderate +6.1 points to -40.1 balance points, while the indicator for business expectations climbed by +18.8 points to -4.4 balance points.

High optimism is fraught with potential for setbacks

German VC investors are becoming increasingly optimistic about the future. The overhang of expectations has never been higher, as business expectations are overtaking the actual situation. This optimism is welcome but it also holds a particularly high potential for setbacks if expectations go unfulfilled. The new optimism also involves the assessments of important factors. Expectations around fundraising, the exit environment and investment appetite are therefore more positive, sometimes much more positive, than current situation assessments.

The fundraising situation has become extreme. While investors still rated the situation and expectations similarly in the first quarter, situation assessments slipped to a new all-time low in the second quarter. At the same time, expectations improved substantially. This is unprecedented in two ways: First, there has never been such a strong countermovement in fundraising and second, never before has there been such a wide gap between the situation and the expectations component. The current drop in the assessments of the fundraising situation to a new low could indicate that fundraising processes are taking increasingly longer and that fundraising targets need to be revised downward if a closing can be achieved at all. First-time funds in particular, which cannot yet draw on an investor base, are likely to have problems here. The strongly improved expectations component, on the other hand, is a hopeful sign.

Development of venture capital sentiment indicator



Key data of venture capital sentiment components

Values in balance points

	Q2/23	Δ Q1/23	Low	High
Business climate	-22.2	↑+12.4	-61.8	+44.0
Business situation	-40.1	↑+6.1	-57.2	+47.7
Business expectations	-4.4	↑+18.8	-70.5	+43.9
Fundraising	-39.5	↑+5.0	-69.1	+71.9
Entry valuations	+31.4	↑+14.9	-54.2	+49.9
Exit opportunities	-53.4	↓-7.3	-74.2	+71.8
New investment	-8.2	↓-8.5	-72.3	+31.3
Dealflow quantity	+7.6	↔+2.6	-44.9	+33.2
Dealflow quality	+2.6	↓-12.9	-22.9	+28.8
Dealflow innovativeness	+8.7	↔-2.4	-47.9	+36.1
Taxation / regulation	-1.5	↓-9.5	-28.2	+35.3
Depreciations	-23.1	↑+10.9	-48.6	+29.7
Economy	-64.5	↓-12.1	-91.3	+76.3
Interest rates	-105.4	↓-6.2	-105.4	+41.3
Public support	+2.6	↔+3.5	-58.1	+37.3

Colour scheme of sentiment indicator dots: values in the lowest tercile are marked 'red', in the medium tercile 'amber' and in the highest tercile 'green'. Indicator design may lead to deviations from previous publications.

Source: KfW Research, BVK and DBVN.

KfW Research

German Venture Capital Barometer 2nd Quarter 2023

This may mean that an end to the central banks' interest rate trajectories is in sight. Lower venture capital valuations and rebounds in the stock market are likely to cause the venture capital ratio in institutional investors' portfolios to decline again, reducing their reallocation pressure.

Investment climate slightly below average

After a positive development at the start of the year, the investment climate cooled again slightly in the first half of 2023. Assessments of the current business situation, in particular, deteriorated again. Expectations also decreased slightly but they remain in positive territory. The overhang of expectations thus widened here as well and is very high in a long-term comparison. Thus, investors have obviously been rather reluctant to make new investments so far in 2023 but anticipate growing investment activity for the rest of the year.

The restraint currently exhibited by investors is being met with continuing steady and qualified demand for venture capital. The indicators for deal flow quantity and quality are in the upper normal range, which signals above-average investor satisfaction. The environment for valuations, too, continues to signal very good entry prices. The last time the corresponding indicator was on such a high level was more than ten years ago.

Comments on the current trend

Dr Fritz Köhler-Geib,
Chief Economist of KfW

'Sentiment in the German VC market improved towards the middle of the year. But despite the recovery, VC business sentiment remains lacklustre. The positive development is driven by expectations, meaning investors view the rest of the year with greater optimism than the current situation. But the gap between expectations and situation assessments has never been higher. If expectations go unfulfilled for an extended period, that could lead to a countermovement and a renewed deterioration in business sentiment. I believe readjusting our benchmark index will be key. The year 2021 was an outlier. The preceding development is the proper benchmark, and on that basis, the VC investments of the past two half-years are exactly on trend. We can therefore be optimistic about the further development of venture capital in Germany.'

Conversely, good entry valuations typically mean above-average write-down pressure on existing equity investments. This pressure has built up since the interest rate reversal and is leaving its imprint on the portfolios with a delay. Sentiment improved here slightly in the past quarter but remains tense.

Exit environment has suffered a setback

The positive countermovement in the exit environment at the start of the year was short-lived. It dimmed again in the second quarter and therefore remains very poor overall. In particular, situation assessments were lower again, while expectations hardly changed. In a long-term comparison, investor sentiment is similarly poor with respect to individual exit pathways (trade sale, secondary, IPO, buy-back). For all exit pathways, expectations are generally better than assessments of the current situation. Investors thus expect the tight exit environment to improve in the second half of the year, if on a rather low level. A sentiment turnaround is already becoming most evident with respect to trade sales.

Ulrike Hinrichs,
Managing Director of the German Private Equity and Venture Capital Association (BVK)

'After a very difficult year 2022, optimism has returned to the community of venture capital investors. It is still fragile, to be sure, but they are looking to the future with much more hope, as VC investors typically do', she commented. 'It is true that VCs continue to watch important conditions such as the interest rate level, business cycle, exit and fundraising environment with a critical eye. But this is not weighing as heavily on the overall mood and, in particular, expectations as it did just at the end of last year. Optimism looks set to drive investment activity in the second half-year as well, so we expect a recovery here.'

Calculation of the German Venture Capital Barometer

The **German Venture Capital Barometer** is based on a quarterly survey of the members of the German Private Equity and Venture Capital Association (Bundesverband Deutscher Kapitalbeteiligungsgesellschaften – BVK), the member investors of the Deutsche Börse Venture Network (since the 2nd quarter of 2021) and further private equity companies with registered offices in Germany. It reports the business climate in the German venture capital market on the basis of assessments provided by private equity firms with a focus on young companies. All sentiment indicators represent the average of the balance of situation assessments (share of 'good' minus share of 'bad') and the balance of expectations identified at the same time for the coming six months, normalised to their respective historical mean balance values as baseline level. As a result, the maximum or minimum value of the indicator may exceed or fall below +100 or -100 as the actual maximum or minimum. Because of the way the barometer is constructed, positive indicator values point to above-average sentiment and negative values to below-average sentiment.

The **German Private Equity and Venture Capital Association (BVK)** is the voice and the face of the private equity industry in Germany. The association is committed to improving conditions and facilitating access to private equity so that even more businesses in Germany can benefit from private equity. It has some 300 members. These include around 200 private equity companies and investors as well as some 100 consulting firms and service providers of the industry.



The **Deutsche Börse Venture Network (DBVN)** was launched in 2015 and is now Europe's largest network for growth finance and 'Capital Market Readiness'. It focuses on providing efficient access to capital and has an extensive range of networking and training services. The network of more than 200 fast-growth businesses and more than 450 investors has already enabled 13 IPOs and numerous trade sales.

Deutsche Börse
Venture Network